

Managing fixed and variable costs in a business essay sample

[Economics](#)



Explain the fixed and variable costs in relation to the organization

In management accounting, cost management has a crucial role and finds its foundations in understanding “ cost behavior”. “ Cost behavior analysis” can be defined as “ the study of how cost changes when there is a change in an organization’s level of activity”.

Managers need to analyze the behavior of three different types of costs:

- Fixed costs;
- Variable costs;
- Semi-Variable (or mixed) costs.

A “ Fixed cost” can be defined as “ a cost that does not change with an increase or decrease in the number of goods or services produced or sold”. It is time-related.

“ Fixed costs remain constant as they are not affected by the changes in the activity. It does not make a difference if the organization is producing/selling or not. Fixed costs will still be paid. Example of fixed costs can be: Rent for the space the organization occupies, Insurances, Property taxes, Depreciation of Assets. This cost is not static and constant forever, but it does not change for a relevant range of volume. For example, if the organization decided to expand, fixed costs will definitely increase. On the other hand, if the organizations reduce the number of employees or use a less expensive workplace, the fixed costs decrease and the cash flow improves.

A “ variable cost” can be defined as “ a cost that does vary depending on the organization’s amount of goods produced or services sold”.

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Therefore, if there is an increase in production/sales, the variable cost will increase and in the same way, if there is no production/sales, there will be no variable cost. This cost changes in total, but it remains the same per unit.

Example of variable costs can be: Direct material costs, like packaging costs that will proportionally change based on the number of units produced; Management tends to manipulate the production/sales to change the variable costs.

Additionally, there are semi-variable (or mixed) costs. A “ semi-variable cost” is a “ cost that has both fixed and variable components. This cost is fixed for a set amount of produced products or sold services and becomes variable after this amount of production/sales is exceeded. If no production occurs, the fixed component still occurs”. A perfect example of semi-variable cost are the utilities, that are determined by a monthly flat rate as per contract and an overage charge based on usage. A semi-variable cost with the lower fixed component is favorable for the organization as it requires a lower break-even point. The terms variable and fixed costs related to a hotel are used to distinguish between those costs that have or do not have a direct relationship to occupancy.

Considering my specific area of work (Room Division),

- examples of fixed costs are: annual salaries (i. e. Director of Rooms’ salary, paid irrespective of the number of hours worked), yearly external auditing cost, licenses and permits, training cost, out-sourced services contracted for a monthly fixed amount;

- examples of variable costs are: guest supplies, cleaning supplies,

complimentary services, and gifts;

- example of semi-variable costs: Energy, House Telecommunication.

The example below clearly demonstrates fixed, variable and semi-variable costs' behavior within the room department. It enables to establish the Guest Supplies cost for August (having a forecast of 4200 room nights sold) by considering the recorded ones for June and July.

June July August Formulas and Examples

Room nights sold 2, 200 3, 800 4, 200

Guest Supplies

(Variable Cost) 14, 960 25, 840 28, 560 Total cost (14, 960) ÷ Total room nights sold (2200) = Variable Cost per room night (6. 80)

Therefore, Variable Cost pr (6. 80) x Total Room nights (4200) = Total cost £28, 560

Variable cost increases proportionally to the increase of Sales Volume

Room Division Director Salary (Fixed Cost) 6, 000 6, 000 6, 000 It remains the same as not affected by the change in Sales Volume

Energy

(Semi-variable cost) 4, 000 5, 000 5, 250 The Highest Semi-Variable Cost(5, 000)-The Lowest Semi-Variable Cost (4, 000) = Cost Increase (1, 000)

The Highest Room nights (3, 800) - The Lowest Room nights (2, 200) = Room nights Increase (1, 600)

Cost Increase (1, 000) ÷ Room nights Increase (1, 600) = Variable Cost per room night (0. 625)

Variable Cost pr (0. 625) x The Lowest room nights (2, 200)= The Lowest

Total Variable cost (1, 375)

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The Lowest Total semi-variable cost (4, 000) - The Lowest Total variable cost (1, 375) = Total fixed cost (2, 625)

Variable cost pr (0. 625) x Room nights forecast (4200) = Total variable cost (2, 625)

Total variable cost (2, 625) + Total fixed cost (2, 625) = Total semi-variable cost (5, 250)

In conclusion, cost behaviour enables them to control the organisation's cost and make effective decisions. It must be considered in the break-even analysis in order to set prices correctly and ensure profitability. It benefits budgeting and forecastost-classification/)ing as they are more accurate if reflecting cost behaviour patterns.